199908038

U.I.L.
0501.12-02
0513.03-00

Internal Revenue Service

Revision of National Office Technical Advice Memorandum

Previously Released for Disclosure as PLR 9722006

DEC 2 1997

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's E.I.N.:

Conferences Held:

Legend:

X=

Y=

Issues:

(1) Whether the income from revenue accounts 5271.101 (Carrier Billing and Collection - Interstate), 5272.101 (Carrier Billing and Collection - Interstate), and 5272.201 (Carrier Billing and Collection - Intrastate), should be categorized as member, nonmember, or excluded for purposes of calculating the 85 percent income test of section 501(c)(12) of the Internal Revenue Code.

(2) Whether the 85 percent of income test is an absolute rule, or is there a de minimis rule that may be applied under certain circumstances.

(3) Whether revenues collected by an inter-exchange carrier (IC) as an agent for X should be treated as member source income, or whether amounts collected by X as agent for an IC be should treated as member source income for purposes of the 85 percent test.

(4) Should the revenues of both the parent (X) and the subsidiary (Y) be combined for purposes of computing the 85 percent member income requirement for X's continued exemption under section 501(c)(12) of the Code?

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(5) If the total revenues of the parent (X) and subsidiary (Y) should not be combined, can the investment income attributable to the additional investment of X in Y be considered income of X for purposes of the 85 percent test?

(6) If the revenues of the parent (X) and the subsidiary (Y) should be combined, should all of Y's revenues be considered nonmember income because Y did not deal with its customers on a mutual or cooperative basis?

(7) What should be the effective date of any required treatment of: (a) revenues discussed in Issue 1; (b) treatment of inter-carrier revenues discussed in Issue 3; and (c) aggregation of X's and Y's gross receipts as discussed in issues 4, 5, and 6, above.

Facts:

X is a corporation which was created for the purpose of providing telephone services to its members on a cooperative basis. X applied for, and was recognized as an organization exempt from federal income tax under section 501(c)(12) of the Code. X's founders intended that X be a cooperative, formed for the benefit of the rural community it would serve. The services provided by X to its members are those commonly performed by local exchange carriers (LECs).

X's operations are subject to regulation by the Federal Communications Commission at the federal level and by the state's Public Utilities Commission (PUC) at the state level. Regulations at the federal level dictate X's charges for inter-connect services and access. The PUC regulates the monthly basic service rate X charges its members for telephone service and the rate of return it can earn based on its investment in telephone plant. The earnings subject to PUC regulation include charges and services provided for intra-state billing and collection.

X's representative contended that billing and collection revenues should be treated as member-sourced for purposes of the 85 percent member income test of section 501(c)(12) because they are derived from a communication service which is attributable to members' toll calls. X adopted this approach in its Form 990 for its tax year ended December 31, 1990.

In 1980, X created a wholly owned subsidiary, Y. Y was formed to own and operate a non-broadcast facility to distribute

television or radio signals and other programming by wire, cable, microwave, satellite, or other means to subscribers. Y files Form 1120 and lists its business activity as "Sales Service/Rental Cable vision/Lease." Y's service is offered to persons in X's service area and some adjacent territory.

X operates as a cooperative, allocating all its net earnings to its members annually via capital credits allocated pro rata based upon income from members. X includes the earnings of its subsidiary (Y) in the capital credits allocated annually to members on a cooperative basis. X reflects the net earnings of Y as "Other Changes in Fund Balance" on its Form 990 since the amounts reflected on its books for the years in question were undistributed earnings and thus not yet realized on an income tax basis.

During the 1990 tax year, Y's gross receipts were 10.94 percent of the aggregate of X's and Y's gross receipts; gross income attributable to Y's gross receipts and other nonmember income received by X amounted to 25.48 percent of the aggregate of X's and Y's gross receipts. During the 1991 tax year, the corresponding percentages were 15.70 and 27.44. These calculations exclude interest received by X from Y in account 7320.063.

Y does not operate on a cooperative basis and makes no allocation of its net earnings to its customers.

Law:

Section 501(c)(12) of the Code provides exemption from Federal income tax for: "Benevolent life insurance associations of a purely local character, mutual ditch or irrigation companies, mutual or cooperative telephone companies, or like organizations; but only if 85 percent or more of the income consists of amounts collected from members for the sole purpose of meeting losses and expenses."

Section 1.501(c)(12)-1 (a) of the Income Tax Regulations provides that an organization described in section 501(c)(12) must receive at least 85 percent of its income from amounts collected from members for the sole purpose of meeting losses and expenses.

Section 1.501(c)(12)-1(c) of the regulations provides that for taxable years of a mutual or cooperative telephone company beginning after December 31, 1974, the 85 percent member-income test described in paragraph (a) of this section is applied without taking into account income received or accrued from another

telephone company for the performance of communication services involving the completion of long distance calls to, from, or between members of the mutual or cooperative telephone company. For example, if, in one year, a cooperative telephone company receives $85x from its members for telephone calls, $15x as interest income, and $20x as credits under long distance interconnection agreements with other telephone companies for the performance of communication services involving the completion of long distance calls to, from, or between the cooperative's members (whether or not the credits may be offset, in whole or in part, by amounts due the other companies under the interconnection agreements), the member-income fraction is calculated without taking into account, either in the numerator or denominator, the $20x credits received from the other telephone companies.

In Golden Belt Telephone Association, Inc. v. Commissioner, 108 T.C. No. 23 (1977), the Court held that "income received from long-distance carriers for B & C [billing and collection] services is income for the performance of "communication services" within Sec. 501(c)(12)(B)(i), and is therefore not taken into account [excluded] to comply with the "85 percent or more" requirement of Sec. 501(c)(12)(A)."

T.D. 7648, 1979-2 C.B. 229, notes that concern was expressed that the notice of proposed rulemaking (section 1.501(c)(12)-1(c) of the regulations), in discussing amounts earned by telephone companies in connection with completing calls involving members of the cooperative, impliedly made distinctions between incoming and outgoing long distance calls, between revenues collected by the cooperative and revenues collected by another telephone company for long distance calls, and between long distance calls between members of the same telephone cooperative and long distance calls involving a nonmember. Since it was not the intent of the proposed regulations to make these distinctions, the notice is revised to make clear that revenues from all the above types of long distance calls do not enter into the member-income computation.

Rev. Rul. 69-575, 1969-2 C.B. 134, in pertinent part, provides that a farmers' cooperative exempt under section 521 of the Code may establish and control a subsidiary corporation so long as the activities of the subsidiary are activities that the cooperative itself might engage in as an integral part of its operations without affecting its exempt status. The ruling notes that an exempt cooperative may not utilize a subsidiary for the conduct of operations on an ordinary profit-making basis. The ruling held that the parent cooperative lost its exemption because it failed to meet

the 15 percent nonmember purchase limitation of section 521(b)(4) when the gross receipts of the subsidiary were taken into account.

In Puget Sound Plywood, Inc. v. Commissioner, 44 T.C. 305 (1965) acq. 1966-1 C.B. 3, three principles are described as fundamental to cooperative operation: (1) subordination of capital; (2) democratic control; and (3) operation at cost. Subordination of capital requires that control of the cooperative and ownership of the pecuniary benefits arising from the cooperative's business remain in the hands of patrons of the cooperative rather than in non-patron equity investors in the cooperative. To be operating on a cooperative basis, a cooperative must limit the financial return made with respect to its equity capital. In other words, a cooperative may not be operated for the purpose of paying a return on equity investments.

Rationale:

To classify X's revenues for purposes of section 501(c)(12) of the Code, the first inquiry is whether any revenues are excluded from the member income test pursuant to section 501(c)(12)(B)(i). Revenues excluded under this section must satisfy two tests: source and function. Excluded revenues are "received or accrued from another telephone company for the performance of communication services involving the completion of long distance calls to, from, or between ... members." Any non-excluded revenues can then be classified as either member or nonmember-source income (i.e., whether such revenues are "collected from members for the sole purpose of meeting losses and expenses").

In this case, X's billing and collection income is derived from nonmember telephone companies for the performance of communication services which involve X's members. See Golden Belt, cited above. Accordingly, such income would not be characterized as either member income or nonmember income. Instead, it would be excluded from the 85 percent member-income test by section 501(c)(12)(B)(i) of the Code.

Prior to the Revenue Act of 1924, exempt mutual and cooperative telephone companies were required to derive their income solely from members as assessments, dues and fees for the sole purpose of meeting their expenses. The 1924 amendments enacted the 85 percent test, allowing telephone cooperatives and other named mutual companies to derive up to 15 percent of their income from nonmember sources. We know of no subsequent statutory or administrative precedent establishing a de minimis rule for this test.

With respect to Issue (3), income collected from nonmember telephone companies for performing "communication services" involving the completion of long distance telephone calls to, from, or between members is excluded from the 85 percent member-income test under section 501(c)(12)(B) of the Code. This position is also clearly set forth in the underlying regulations and comments from T.D. 7648, cited above.

The Congressional purpose in enacting the 85 percent test requires combining the gross receipts of X and Y. Prior to the Revenue Act of 1924, exempt mutual and cooperative telephone companies were required to derive their income solely from members as assessments, dues and fees for the sole purpose of meeting their expenses. The 1924 amendments enacted the 85 percent test allowing telephone cooperatives and other named mutual companies to derive up to 15 percent of their income from nonmember sources. Pub. L. No. 68-176 § 231(10), 43 Stat. 283 (1924). The floor debate discloses the reasons for allowing a minimal amount of nonmember income:

> Mr. Dickinson: Now, every once in a while there are some of these [mutual insurance] companies which have a few thousand dollars which they want to put on time deposit, and they will put it in a bank for a short time on time deposit. If you do not provide that the principal sources of income shall consist of amounts collected from members, you bar them from having those little incidental revenues which they make out of the small matters.

Cong. Rec. Vol. 65 at 2866-2867 (1924).

> Mr. Purnell: [T]hese companies were not able to set aside any surplus; they were not able to expand; they were not able to buy any buildings; thrift was not only discouraged but penalized; they were not able to accept interest on daily balances in banks.

Cong. Rec. Vol. 65 at 2867-2900 (1924).

Although the Congressional debate centered on mutual insurance companies, the new 85 percent test applied to mutual and cooperative telephone companies. Congress intended that telephone companies also be allowed a minimal amount of nonmember income necessary to expand, buy buildings or earn interest on bank

accounts. The 1916 and 1924 acts refer to "conditional exemption" for telephone cooperatives. The 85 percent test in section 501(c)(12) should be read together with the legislative history. We do not believe that Congress intended that a telephone cooperative can shelter nonmember income from the 85 percent test by placing nonmember income in a controlled corporation. Were it otherwise, the purpose of the 85 percent test (exemption conditioned on substantial income from providing cooperative telephone service to members) would be nullified.

In determining whether the gross receipts of X and Y should be combined for purposes of the 85 percent test, we believe that cooperative principles espoused in Rev. Rul. 69-575 are applicable and controlling in this case. In order for X to create the subsidiary Y and maintain its exemption under section 501(c)(12) of the Code, Y must have been created to perform a function that X itself might engage in as an integral part of X's operations without affecting X's exempt status. Y was created and utilized for the conduct of operations on an ordinary profit-making basis. Y was created for the purpose of providing cable television service to the customers of Y, in contrast to X whose basis for exemption is the provision of telephone service to its members on a cooperative basis. Y does not operate on a cooperative basis. All profits of Y are treated as taxable income with the net profit turned over to X as non-patronage income.

The operations of Y, conducted on a non-cooperative basis, could clearly not be conducted by X as an integral part of that cooperative without affecting its exemption because such operations would cause X to violate the fifteen percent nonmember income requirement. Consistent with the example noted in Rev. Rul. 69-575, cited above, the gross receipts of Y must be aggregated with those of X for purposes of calculating the 85 percent member income test. Moreover, because these receipts are derived from an activity which is not the basis of X's exemption, they must be classified as non-member income.

Conclusions:

(1) Billing and collection revenues from accounts 5271.101, 5272.101, and 5272.201, are revenues from nonmember sources for "communications services" which involve X's members, and should be excluded when calculating the 85 percent member income test.

(2) There is no statutory or administrative precedent for applying a de minimis rule in the computation of the 85

percent member income test for organizations exempt under section 501(c)(12).

(3) Revenues collected by an inter-exchange carrier, (IC) as an agent for X and revenues collected by X as an agent for an IC must be excluded for purposes of the 85 percent member income test.

(4) Pursuant to the holding of Rev. Rul. 69-575, the 85 percent test must be applied to the combined gross receipts of X and Y, effective with the tax year beginning January 1, 1999, as indicated in conclusion (7), below.

(5) The investment income (interest and dividends) received by X from Y will be considered nonmember income of X for purposes of the 85 percent test in those tax years when X is not required to aggregate its gross receipts (those years beginning before January 1, 1999). For the tax year beginning January 1, 1999, and subsequent years this income will not be subject to the 85 percent member income test since it is an "intercompany" transaction.

(6) Y's total revenues will be treated as nonmember income by X in those years in which aggregation is required.

(7) The Assistant Commissioner has exercised her discretion and granted the specific relief requested under section 7805(b) of the Code with respect to the position taken in conclusion (4). Conclusion (4) will be effective for the tax year beginning January 1, 1999, and all subsequent years.

A copy of this technical advice memorandum is to be given to the organization. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

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